



# SEC

OFFICE of INVESTOR  
EDUCATION and ADVOCACY

## Ponzi Schemes – Frequently Asked Questions

### What is a Ponzi scheme?

A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. Ponzi scheme organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk. In many Ponzi schemes, the fraudsters focus on attracting new money to make promised payments to earlier-stage investors and to use for personal expenses, instead of engaging in any legitimate investment activity.

### Why do Ponzi schemes collapse?

With little or no legitimate earnings, the schemes require a consistent flow of money from new investors to continue. Ponzi schemes tend to collapse when it becomes difficult to recruit new investors or when a large number of investors ask to cash out.

### How did Ponzi schemes get their name?

The schemes are named after Charles Ponzi, who duped thousands of New England residents into investing in a postage stamp speculation scheme back in the 1920s. At a time when the annual interest rate for bank accounts was five percent, Ponzi promised investors that he could provide a 50% return in just 90 days. Ponzi initially bought a small number of international mail coupons

in support of his scheme, but quickly switched to using incoming funds to pay off earlier investors.

### Does the SEC investigate Ponzi schemes?

The SEC investigates and prosecutes many Ponzi scheme cases each year both to prevent new victims from being harmed and to maximize the recovery of assets to investors. The majority of such cases are brought as emergency actions, which often seek a temporary restraining order and an asset freeze.

During 2009, the SEC filed 60 enforcement actions involving Ponzi schemes or Ponzi-like payments, including charging Robert Allen Stanford and his companies with allegedly conducting an \$8 billion Ponzi scheme.

### Who is Bernie Madoff?

Bernard L. Madoff, who is currently serving a 150-year sentence in federal prison, orchestrated a multi-billion dollar Ponzi scheme that swindled money from thousands of investors. Unlike the promoters of many Ponzi schemes, Madoff did not promise spectacular short-term investment returns. Instead, his investors' phony account statements showed moderate, but consistently positive returns — even during turbulent market conditions.

In December 2008, the SEC charged Bernard Madoff and his investment firm, Bernard L. Madoff Investment

Securities LLC, with securities fraud for the multi-billion dollar Ponzi scheme he perpetrated on advisory clients of his firm for many years. The SEC filed emergency motions to freeze assets and appoint a receiver, and worked to return as much money as possible to harmed investors.

Madoff had been a prominent member of the securities industry throughout his career. He served as vice chairman of the NASD, a member of its board of governors, and chairman of its New York region. He was also a member of NASDAQ Stock Market's board of governors and its executive committee and served as chairman of its trading committee. Madoff founded his investment advisory firm in 1960.

### How is the SEC responding to its Office of Inspector General's reports on the Madoff fraud?

In August and September 2009, the SEC's Office of Inspector General issued three reports on the Madoff fraud, including one entitled Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme. The SEC has closely analyzed the reports.

Even before the release of these reports, major efforts were underway to make improvements and address the shortcomings that were identified in the reports. A list of decisive and comprehensive steps the SEC is taking to reduce the chances that similar frauds will occur or be undetected in the future is available on the SEC's Post-Madoff Reforms web page, [www.sec.gov](http://www.sec.gov).

### What are some Ponzi scheme "red flags"?

Many Ponzi schemes share common characteristics. Look for these warning signs:

- **High investment returns with little or no risk.**  
Every investment carries some degree of risk, and investments yielding higher returns typically involve more risk. Be highly suspicious of any "guaranteed" investment opportunity.
- **Overly consistent returns.**  
Investments tend to go up and down over time, especially those seeking high returns. Be suspect of an investment that continues to generate regular, positive returns regardless of overall market conditions.
- **Unregistered investments.**  
Ponzi schemes typically involve investments that have not been registered with the SEC or with state regulators. Registration is important because it provides investors with access to key information about the company's management, products, services, and finances.
- **Unlicensed sellers.**  
Federal and state securities laws require investment professionals and their firms to be licensed or registered. Most Ponzi schemes involve unlicensed individuals or unregistered firms.
- **Secretive and/or complex strategies.**  
Avoiding investments you don't understand or for which you can't get complete information is a good rule of thumb.
- **Issues with paperwork.**  
Ignore excuses regarding why you can't review information about an investment in writing, and always read an investment's prospectus or disclosure statement carefully before you invest. Also, account statement errors may be a sign

that funds are not being invested as promised.

- **Difficulty receiving payments.**

Be suspicious if you don't receive a payment or have difficulty cashing out your investment. Keep in mind that Ponzi scheme promoters sometimes encourage participants to "roll over" promised payments by offering even higher investment returns.

If you are aware of an investment opportunity that might be a Ponzi scheme, contact the SEC by phone at (800) 732-0330 or online at <http://www.sec.gov/complaint.shtml>.

### **What steps can I take to avoid Ponzi schemes and other investment frauds?**

Whether you're a first-time investor or have been investing for many years, there are some basic questions you should always ask before you commit your hard-earned money to an investment.

The SEC sees too many investors who might have avoided trouble and losses if they had asked questions from the start and verified the answers with information from independent sources.

### **When you consider your next investment opportunity, start with these five questions:**

1. Is the seller licensed?
2. Is the investment registered?
3. How do the risks compare with the potential rewards?
4. Do I understand the investment?
5. Where can I turn for help?

For more information, read *Investing Smart from the Start: Five Questions to Ask Before You Invest*, available on [www.sec.gov](http://www.sec.gov).



## What are some of the similarities and differences between Ponzi and pyramid schemes?

Ponzi and pyramid schemes are closely related because they both involve paying longer-standing members with money from new participants, instead of actual profits from investing or selling products to the public. Here are some common differences:

	Pyramid Scheme	Ponzi Scheme
<b>Typical “hook”</b>	Earn high profits by making one payment and finding a set number of others to become distributors of a product. The scheme typically does not involve a genuine product. The purported product may not exist or it may only be “sold” within the pyramid scheme.	Earn high investment returns with little or no risk by simply handing over your money; the investment typically does not exist.
<b>Payments/profits</b>	Must recruit new distributors to receive payments.	No recruiting necessary to receive payments.
<b>Interaction with original promoter</b>	Sometimes none. New participants may enter scheme at a different level.	Promoter generally acts directly with all participants.
<b>Source of payments</b>	From new participants – always disclosed.	From new participants – never disclosed
<b>Collapse</b>	Fast. An exponential increase in the number of participants is required at each level.	May be relatively slow if existing participants reinvest money.

